

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:LM:HMT:CIN:2:POSTF-113432-02

GRShuler

date:

to: [REDACTED], Case Coordinator

Attn: [REDACTED], Engineer Specialist, LMSB Group [REDACTED]

from: Associate Area Counsel (Large and Mid-Size Business)  
Cincinnati, Ohio CC:LM:HMT:2

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subject: Valuation Date for [REDACTED] Reorganization

This memorandum responds to your request for assistance dated March 6, 2002. This memorandum should not be cited as precedent.

You have requested assistance in ascertaining the appropriate valuation date for a corporate reorganization. Based on the information you provided, we agree with your position that [REDACTED], is the appropriate valuation date. However, in determining fair market value, a taxpayer may rely on foreseeable factors that affect valuation.

**ISSUES**

1. What is the appropriate valuation date for valuing the equity of [REDACTED] and its wholly owned subsidiaries, [REDACTED] and [REDACTED]?
2. In valuing a corporation's equity, which includes rental property, can the taxpayer anticipate earnings or other subsequent events to demonstrate or corroborate existing values?

**CONCLUSIONS**

1. The appropriate valuation date is the date of the reorganization, [REDACTED].
2. The value of [REDACTED], and its assets, should be determined on the basis of facts known at the time of the reorganization. However, subsequent events or earnings, when reasonably anticipated, may be shown to demonstrate or corroborate existing values.

**FACTS**

The facts as we understand them follow. [REDACTED] (" [REDACTED] ") is a corporation incorporated in Delaware. Prior to [REDACTED], [REDACTED] (then known as [REDACTED]) owned and operated approximately [REDACTED] and [REDACTED]. Pursuant to the Agreement and Plan of Reorganization dated [REDACTED], [REDACTED] transferred its non-real estate operations to [REDACTED]. The reorganization was a taxable transaction.

On [REDACTED], [REDACTED] changed its name from [REDACTED] to [REDACTED]. Also, on [REDACTED], [REDACTED] changed its name to [REDACTED]. [REDACTED] has since been renamed [REDACTED].

On [REDACTED], [REDACTED] transferred accounts receivable, certain real properties, tangible personal property, various operating assets, stock in subsidiaries and interests in several partnerships to [REDACTED]. In exchange for these assets, [REDACTED] issued common stock to [REDACTED] and assumed liabilities of [REDACTED]. The liabilities assumed by [REDACTED] included debt related to a \$ [REDACTED] tender offer for senior subordinate notes and any notes that remained outstanding.

On [REDACTED], the day after the reorganization, [REDACTED] distributed the stock of [REDACTED] to its stockholders. Also, on [REDACTED], [REDACTED] and [REDACTED] executed a series of Master Lease Agreements. The agreements governed the rental payments that [REDACTED] was required to pay [REDACTED] for the properties that [REDACTED] leased to [REDACTED]. The amounts due under the agreements were based on [REDACTED] books. The rental payments were equivalent to [REDACTED] times the stated tax basis of the previous rental payments. Under the agreements, rental payments were due on the first of each month. The first rental payments that were due under the agreements were due on [REDACTED].

Subsequent to the reorganization, [REDACTED] hired [REDACTED] to provide appraisal services for the valuation of [REDACTED] and its wholly owned subsidiaries, [REDACTED] and [REDACTED]. Specifically, [REDACTED] rendered its opinion of the fair market value of the stockholders' equity as of [REDACTED]. The specific methodology used by [REDACTED] in providing its appraisal was a combination of the income and market approaches.

In determining the value of potential rental income that [REDACTED] could earn, [REDACTED] used the stated contract rates in the rental agreements executed on [REDACTED], rather than fair rental values based upon market comparables. [REDACTED] did not discount this amount for the time that it would have taken [REDACTED] to earn it, but did apply a discount of [REDACTED]% for earnings on investment.

### LEGAL ANALYSIS

#### 1. Date of Valuation

The determination of gains and losses on the disposition of property is governed by I.R.C. § 1001. Commissioner v. Tufts, 461 U.S. 300, 304 (1983). Section 1001(a) provides in part that the gain from the sale or other disposition of property will be the excess of the amount realized over the adjusted basis provided in section 1011 for determining gain. When basis for property is determined, it is valued as of the particular date when property was acquired, transferred, sold, bequeath, devised or distributed. See I.R.C. § 1011. In determining the particular date, the transaction must be viewed as a whole and in the light of realism and practicality. See Commissioner v. Segall, 114 F.2d 706 (6<sup>th</sup> Cir. 1940), cert. denied, 313 U.S. 562 (1941).

In this case, the reorganization occurred on [REDACTED] when the Agreement and Plan of Reorganization became effective. Also on this date, [REDACTED] transferred assets including accounts receivable, real properties, operating assets, tangible personal property, stock in subsidiaries and interests in partnerships to [REDACTED]. On this same date, in exchange for the aforementioned assets, [REDACTED] issued common stock to [REDACTED] and assumed its liabilities. Clearly, the assumption of benefits and burdens of ownership occurred on [REDACTED] when the reorganization occurred and there was a series of transactions. See Perry v. Commissioner, T.C. Memo. 1976-381. Accordingly, the proper date for valuing the taxpayer's stock was the date of the reorganization on [REDACTED]. See, e.g., Herbert J. Inv. Corp. v. United States, 360 F. Supp. 825 (E.D. Wis. 1973), aff'd, 500 F.2d 44 (7<sup>th</sup> Cir. 1974).

Based on the information previously provided<sup>1</sup>, we do not think that the taxpayer is disputing the date of the valuation. In a letter dated [REDACTED], from [REDACTED] to [REDACTED], [REDACTED] restates the scope and terms of the appraisal

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<sup>1</sup> A fax and accompanying documents on [REDACTED].

arrangement. This letter clearly states that [REDACTED] was using [REDACTED], as the date for determining the "controlling interest basis." Accordingly, we believe the issue is properly stated as whether [REDACTED] can use future events, specifically the signing of the rental contracts and projected stream of rental income, in determining the value of its assets on [REDACTED].

## 2. Foreseeable Factors Affecting the Fair Market Value

For Federal income purposes, the fair market value of property is the price that a willing buyer would pay a willing seller for that property, neither one being under any compulsion to buy or sell and both having reasonable knowledge of all the relevant facts. I.R.C. § 1001(b); United States v. Cartwright, 411 U.S. 546, 551 (1973). The buyer and the seller are hypothetical, and their characteristics are not necessarily the same as the personal characteristics of the actual seller or of a particular buyer. Propstra v. United States, 680 F.2d 1248, 1251-1252 (9<sup>th</sup> Cir. 1982).

The burden of proving the fair market value is on the taxpayer. Fair market value involves a question of fact, and facts reasonably known on the valuation date are particularly relevant. One of the important components for valuing stock which is not bought and sold freely is the value of tangible and intangible assets of the company. The value of assets should be determined on the basis of facts known at the time of acquisition. However, subsequent events or earnings, when reasonably anticipated, may be shown to demonstrate or corroborate existing values.

Income that can reasonably be anticipated from ownership of assets on the basic date may influence its value. The use of subsequent earnings for the determination of an asset value is justified, if from past experience and facts definitely known at the valuation date, such earnings might reasonably be anticipated. See, e.g., Gow v. Commissioner, T.C. Memo. 2000-93, aff'd, 2001-2 USTC ¶ 50646 (4<sup>th</sup> Cir. 2001); Hartmann v. United States, 99-2 USTC ¶ 60349 (C.D. Ill. 1999); Estate of Jung v. Commissioner, 101 T.C. 412 (1993). However, the total earnings expected must usually be discounted for the time that it will take to earn them. See, e.g., Estate of Heck v. Commissioner, T.C. Memo. 2002-34; Estate of Renier v. Commissioner, T.C. Memo. 2000-298.

Similarly, contractual obligations can be valued from the standpoint of receipt of expected payments and anticipated monetary loss due to the time value of money. See, e.g., Tindle v. Heiner, 27 F.2d 1012 (W.D. Pa. 1928) (the value of residential property rented for profit was fixed upon consideration of the increasing value of land, the decreasing value of the building, and decreasing rents); Frizzelle Farms, Inc. v. Commissioner, 61 T.C. 737 (1974), aff'd, 511 F.2d 1009 (4<sup>th</sup> Cir. 1975) (valuation of warrants based on future earning potential); Bardahl v. Commissioner, T.C. Memo. 1965-158 (valuation of closely held stock based on anticipated earnings). The problem of whether a contract has an ascertainable fair market value has been the subject of extensive litigation over the years and has been resolved as a question of fact rather than one of law. Estate of Marsack v. Commissioner, 288 F.2d 533 (7<sup>th</sup> Cir. 1961). There is nothing inherent in a contract or claim for future payment of indefinite amounts that cause them to be insusceptible of valuation at that time. Although the task of valuing a contract may be difficult, it is superable; given all relevant evidence from which value is usually determined, it is only in rare and extraordinary cases that the property would have no reasonably ascertainable fair market value. See, e.g., Chamberline v. Commissioner, 32 T.C. 1098 (1959), aff'd, 286 F.2d 850 (7<sup>th</sup> Cir. 1960), cert. denied 368 U.S. 820 (1961).

In this case, the rental payments due under the agreements were based on previous book value and increased almost [REDACTED] percent for reasons which we do not know. Variances in accounting periods, accounting practices, and management policies generally make it impossible to use book values as a reliable guide for valuation purposes. Furthermore, no value can be allowed for a leasehold when the rental payments required under it exceeded the actual fair rental value of the premises. Rauh Realty Co. v. Commissioner, 26 B.T.A. 48 (1932), acq., 1932-2 C.B. 8.

Although there is a striking discrepancy in quantity of the rental amounts prior to the reorganization and thereafter, there are several possible explanations for the discrepancy in the values, not all of which indicate that the latter value is incorrect. For example, it is possible that an unusually large change in real estate values in general occurred during the relevant period. There may have been a change in character of the location where the property was situated or a change in the business character of the location. In addition, the lessor may have done something to the properties, in the nature of repairs and improvements, to make them more valuable. Apparently none of the above elements factored into the valuation of the rental agreements by [REDACTED]. The appraisal of [REDACTED]

relied exclusively on the contractual payments. We believe [REDACTED] would have great difficulty defending such a position for the reasons that follow.

A taxpayer can look to foreseeable events such as an anticipated stream of income to value its assets. At a minimum, the taxpayer must take into consideration the potential uncertainties as to the future receipt of payments. For example, the taxpayer should consider the time that it will take to earn that money, as well as consider other possible intervening events. Factors that would affect fair rental value include whether the rental agreements were subject to renegotiation or termination. In this case, we note that the rental agreements contained provisions for termination. Therefore, it is possible that Ventas may not have received any future income other than that required to be paid pursuant to the termination provisions.

We are not aware of the circumstances under which the lease agreements were negotiated. The agreements were signed one day after the reorganization. Although technically unrelated when the agreements were signed, the parties were clearly negotiating the terms of the agreements when the parties were related. Transactions between related parties should be closely scrutinized. Estate of Trenchard v. Commissioner, T.C. Memo. 1995-121. Evidence of other leases and rents paid under comparable leases should have been used as a competent source to establish value. See, e.g., Crocker v. Commissioner, T.C. Memo. 1998-204. Furthermore, the mere fact that a lease amount was agreed to between unrelated parties does not, in and of itself, indicate that amount is the result of arm's length negotiations. See, e.g., Kloppenberg & Co. v. Commissioner, T.C. Memo. 1986-325 (valuation of property not a focus of four month negotiations, where parties were indifferent as to property value so long as stated value was sufficient to provide security for a note).

#### SUMMARY

The valuation date is [REDACTED]. Since the lease agreements were signed the day after the reorganization, we would suspect that [REDACTED] and [REDACTED] had been in discussions prior to [REDACTED], as well as [REDACTED], for the rental of the properties. As such we believe, the methodology used by [REDACTED] in its appraisal is flawed. We believe the rental agreements have some value but not as high as stated by [REDACTED].

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please contact Senior Attorney Gary R. Shuler, Jr. at (513) 263-4894 if you have any questions or need additional assistance,

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